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Memorandum

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Subject: Montana Underreporting Income Tax Gap

In 2006, the Department of Revenue estimated that Montana's underreporting tax gap for the state's individual income tax was approximately \$243 million in fiscal year (FY) 2005. The \$243 million was equivalent to 26.6 percent of the income tax revenue generated by the state during the FY. This memorandum provides updated underreporting tax gap estimates for Montana, using updated national tax gap estimates and state specific income tax records. Overall, Montana's underreporting tax gap for FY 2017 was estimated to be approximately \$270.6 million, which is approximately 19.2 percent of the total amount of income tax revenue collected during the year.

National Tax Gap Estimates

In 2016, the Internal Revenue Service (IRS) released a report examining the federal income tax gap. Unlike previous reports, which examined a single year, the 2016 report estimated the annual average tax gap for three tax years, 2008 through 2010. The expansion of the estimates to multiple tax years were designed to pool compliance data from multiple years and provide more reliable tax gap estimates.

For all tax types, the IRS estimates the annual average federal gross tax gap was \$458 billion between the three examined years. The largest source of the federal tax gap was due to the underreporting of income (Figure 1). The average amount of income lost to income underreporting was \$387 billion. The underpayment of taxes and the non-filing of taxes also contributed to the federal tax gap. The IRS estimates that \$39 billion of taxes were not paid during each of the three years as the result of underpayments. The non-filing of taxes also resulted in \$32 billion in lost tax revenue because of individuals and organizations not filing their taxes.

Figure 1	
National Gross Tax Gap Estimates For Tax Years 2008 - 2010	
Gross Tax Gap	Annual Average (Billions of Dollars)
Nonfiling	\$32
Underreporting	\$387
Underpayment	\$39
Voluntary Compliance Rate	81.7%

The underreporting tax gap from the individual income tax was the largest, with a tax gap of approximately \$264 billion (Figure 2). Underreporting of employment and corporate income taxes also generated significant reductions in tax revenue, with tax gaps of \$81 billion and \$41 billion respectively. The remainder of the federal tax gap was primarily comprised of underpayment and non-filing tax gaps from the individual income tax.

Figure 2		
Annual Average Gross Tax Gap Estimates For Tax Years 2008 - 2010		
Tax Gap Component	Tax Gap (Billions of Dollars)	Share of Gross Tax Gap
Gross Tax Gap	\$458	100%
Nonfiling Tax Gap	\$32	7.0%
Individual Income Tax	\$26	5.7%
Self-Employment Tax	\$4	0.9%
Estate Tax	\$2	0.4%
Underreporting Tax Gap	\$387	84.5%
Individual Income Tax	\$264	57.6%
Corporation Income Tax	\$41	9.0%
Employment Tax	\$81	17.7%
Estate Tax	\$1	0.2%
Underpayment Tax Gap	\$39	8.5%
Individual Income Tax	\$29	6.3%
Corporation Income Tax	\$3	0.7%
Employment Tax	\$6	1.3%
Estate Tax	\$1	0.2%

The underreporting tax gap for the individual income tax can be broken down by income type. Underreporting of non-farm business income generated the largest federal revenue loss, at \$78 billion on average each year (Figure 3). Rent, royalties, partnership, S-corp, estate and trust income was the second largest source of revenue loss, with a combined \$42 billion in underreported tax revenue. Income loss from the underreporting of capital gains and other income were also large sources of revenue loss, with \$11 billion and \$29 billion in lost revenue respectively. All combined, these four income sources comprised more than 60 percent of individual income taxes' underreporting tax gap and nearly 35 percent of the total gross tax gap.

Figure 3				
Average Annual Federal Underreporting Individual Income Tax Gap By Income Source, 2008 - 2010				
(Billions of Dollars)				
Tax Return Line Items	Total Tax Revenue Due	Reported Tax Revenue	Tax Gap	Net Misreporting Percentage
Gross Tax Gap			\$458	
Individual Income Tax Underreporting Tax Gap	\$1,200	\$936	\$264	22%
Wages, salaries, tips	\$500	\$495	\$5	1%
Interest income	\$33	\$32	\$1	3%
Dividend income	\$14	\$13	\$1	7%
State income tax refunds	\$8	\$7	\$1	13%
Pensions & annuities	\$125	\$120	\$5	4%
Unemployment Compensation	\$17	\$16	\$1	6%
Taxable Social Security benefits	\$37	\$30	\$7	19%
Partnership, S-Corp, Estate & Trust, etc	\$138	\$116	\$22	16%
Capital gains	\$41	\$30	\$11	27%
Short-term	\$46	\$40	\$6	13%
Long-term	\$38	\$33	\$5	13%
Form 4797 income	\$10	\$6	\$4	42%
Other income	\$59	\$30	\$29	49%
Nonfarm proprietor income	\$122	\$44	\$78	64%
Farm income	\$7	\$2	\$5	71%
Rents & royalties	\$32	\$12	\$20	62%
Other Taxes	\$33	\$32	\$1	3%
Unallocated Marginal Effects			\$12	
Income Offsets (Adjustments, Deductions, Exemptions)	\$380	\$361	\$19	5%
Total Credits	\$154	\$114	\$40	26%
Filing Status			\$5	

Income from sources with little information reporting showed the largest misreporting of income. For example, the IRS estimates that approximately 71% of farm income is misreported (Figure 3). As a result, farm income should be generating \$7 billion in tax revenue each year, instead of the \$2 billion it actually generated. The IRS also found significant underreporting of nonfarm business income, and rent and royalty income, with misreporting percentages of 64 percent and 62 percent respectively. At the same time, income from sources with substantial reporting from secondary sources showed relatively small misreporting shares. Wage, salary and tip income, which has information reporting and withholding, reported the smallest misreported percentage, with only 1 percent of income not reported.

Montana Tax Gap Estimate

Underreporting tax gap estimates for Montana's individual income tax were generated using the national misreporting percentages provided by the IRS. Montana's individual income tax return requires taxpayers to report all the income reported on their federal tax return associated with their federal adjusted gross income. To generate a tax gap estimate, the reported income for each tax return were adjusted based on the national

misreported percentages provided by the IRS in the previous section. When the income of full-year resident taxpayers were adjusted, Montana's taxable income increased from \$26.4 billion to \$31.6 billion. In addition, adjustments to federal adjusted gross income, deductions, exemptions and credits decreased, on net, from \$10.9 billion to \$10.4 billion once the IRS misreporting adjustments were made.

Figure 4 Average Annual Montana Underreporting Individual Income Tax Gap By Income Source, 2016					
Tax Return Line Items	Total Income	Reported Income	Reported Losses	Amount Mis-Reported	Net Misreporting Percentage
Individual Income Tax Underreporting Tax Gap					
Wages, salaries, tips	\$16,961,548,131	\$16,791,932,650	\$0	\$169,615,481	1%
Interest income	\$305,003,079	\$295,852,987	\$0	\$9,150,092	3%
Dividend income	\$742,184,620	\$690,231,697	\$0	\$51,952,923	7%
State income tax refunds	\$128,649,722	\$111,925,258	\$0	\$16,724,464	13%
Pensions & annuities	\$3,123,519,218	\$2,998,578,449	\$0	\$124,940,769	4%
Unemployment Compensation	\$100,985,200	\$94,926,088	\$0	\$6,059,112	6%
Taxable Social Security benefits	\$1,211,783,826	\$981,544,899	\$0	\$230,238,927	19%
Rents, Royalties and Partnerships, S-Corp, Estate & Trust, etc	\$3,802,194,250	\$3,152,795,429	(\$501,916,236)	\$1,151,315,057	25%
Capital gains	\$2,251,472,796	\$1,680,082,250	(\$63,512,368)	\$634,902,914	27%
Form 4797 income	\$202,501,626	\$143,299,621	(\$63,284,694)	\$122,486,699	42%
Other income	(\$195,141,908)	\$132,515,405	(\$677,914,293)	\$350,256,980	49%
Nonfarm proprietor income	\$2,798,623,573	\$1,048,258,449	(\$185,656,941)	\$1,936,022,065	64%
Farm income	\$216,368,387	\$122,706,490	(\$353,555,224)	\$447,217,121	71%
Federal adjustments to income	\$508,553,396	\$536,806,362	\$0	\$28,252,966	5%
State additions to federal income	\$839,811,818	\$797,821,227	\$0	\$41,990,591	5%
State subtractions from federal income	\$1,592,930,557	\$1,681,426,699	\$0	\$88,496,142	5%
Deductions	\$5,092,000,521	\$5,374,889,439	\$0	\$282,888,918	5%
Exemptions	\$2,322,730,686	\$2,451,771,280	\$0	\$129,040,594	5%
Non-refundable Credits	\$27,474,820	\$42,357,014	\$0	\$14,882,194	26%
Refundable Credits	\$4,225,369	\$6,514,110	\$0	\$2,288,741	26%

After the adjustments were made, each tax return is run through the 2016 tax simulation model to generate updated tax liability estimates for each full-year resident taxpayer. An estimate of each taxpayer's tax gap was then generated by comparing their original tax liability to the new tax liability with the adjusted incomes. When combined, the tax liability of full-year residents before tax credits increased from \$1.02 billion to \$1.24 billion, an increase of approximately \$222 million (Figure 5). Using the IRS estimates of misreporting increases the tax liability of full-year Montana residents who file a return by 21.7 percent.

Figure 5 Simulated 2016 Full Year Resident Montana Tax Liability, Million of Dollars		
	Tax Liability	% Difference
With 2016 Returns	\$1,022	
With IRS Tax Gap Under-Reporting Estimates	\$1,244	21.7%

The \$222 million estimate is not the entire underreporting tax gap estimate for Montana, as it does not include non-resident taxpayers or tax credits. To generate a tax gap estimate that includes these two factors, the underreporting tax gap percentage can be applied to actual income tax revenue collections. For fiscal year 2017, total income tax revenue was approximately \$1.18 billion (Figure 6). As our tax gap estimate is based on tax revenue before audits and other compliance measures, it is necessary to remove this revenue from the tax revenue amount. For FY 2017, compliance activities and amended returns

generated approximately \$39.7 million in tax revenue. In addition, revenue losses from tax credits need to be added into the total tax revenue estimate. Based on 2016 tax returns, there was approximately \$48.9 million tax credits claimed. When both compliance revenue is removed and credits are added, total FY 2017 tax revenue was approximately \$1.19 billion.

Figure 6	
Estimated FY 2017 Income Tax Revenue	
Less Compliance Revenue Plus Credits	
FY 2017 Income Tax Revenue	\$1,180,343,776
Revenue from Compliance and Amended Returns	- \$39,693,156
FY 2017 Current Income Tax Revenue	\$1,140,650,620
Estimated Credits	+ \$48,871,124
Estimated Current Income Tax Before Credits	\$1,189,521,744

The amount of revenue that would be collected in the absence of a tax gap in Montana was estimated by combining total income tax collections, before compliance efforts, and total credits after both were adjusted based on national IRS misreporting levels. Before credits and compliance efforts, Montana's individual income tax generated approximately \$1.19 billion in revenue for FY 2017. Assuming that national IRS misreporting rates are the same for Montana's residents, non-residents and part-year residents, total income tax collections for FY 2017 would have been 21.7 percent higher if there was no tax gap. As a result, Montana's income tax would have generated \$1.447 billion in tax revenue before credits with no tax gap (Figure 7).

Before adjustments, resident and non-resident taxpayers claimed approximately \$48.9 million in tax credits for tax year 2016 (Figure 7). The IRS estimates that tax credits have a misreporting rate of 26 percent for the nation as a whole. Assuming a similar misreporting percentage holds for Montana, only \$36.2 million in tax credits are reported correctly.

Overall, \$1.411 billion in tax revenue would have been collected in FY 2017 if there were no tax gap, after removing the \$36.2 million in tax credits and before any compliance activities. Actual income tax collections for FY 2017 was \$1.140 billion, before compliance activities and excluding back year taxes. The difference between the two, \$270.6 million, was Montana's tax gap for fiscal year 2017 (Figure 7). Overall, tax revenue would have been 19.2 percent higher in the absence of the gap.

Figure 7	
Estimated FY 2017 Mis-Reporting Tax Gap for Montana Income Tax	
Estimated FY 2017 Current Income Tax Before Credits	\$1,189,521,744
Adjustment for Mis-Reporting of Income and Deductions	X 121.7%
Estimated Tax before Credits, Adjusted for Mis-Reporting of Income and Deductions	\$1,447,448,839
Estimated FY 2017 Credits	\$48,871,124
Adjustment for Mis-Reporting	X 74%
Estimated Credits Adjusted for Mis-Reporting	\$36,164,632
Estimated Tax before Credits, Adjusted for Mis-Reporting of Income and Deductions	\$1,447,448,839
Estimated Credits Adjusted for Mis-Reporting	- \$36,164,632
Estimated FY 2017 Income Tax Revenue Adjusted for Mis-Reporting	\$1,411,284,207
Estimated FY 2017 Income Tax Revenue Adjusted for Mis-Reporting	\$1,411,284,207
FY 2017 Current Income Tax Revenue	- \$1,140,650,620
Estimated Mis-Reporting Gap	\$270,633,587
Estimated % Mis-Reporting Gap	19.2%
Estimated Mis-Reporting Gap for FY 2005	\$243,088,000
Estimated % Mis-Reporting Gap for FY 2005	26.6%
Estimated Mis-Reporting Gap for FY 2015	\$287,210,655
Estimated % Mis-Reporting Gap for FY 2015	20.1%

The tax gap estimate for FY 2017 is slightly below the 20.1 percent that was estimated for FY 2015. The decrease in the tax gap size is primarily driven by the types of income reported by taxpayers. A larger proportion of the income reported in tax year 2016 came from sources with lower estimated levels of misreporting. For example, wage and salary income, which has the lowest amount of misreporting, comprised 63.6 percent of income in tax year 2016 and 62.7 percent of reported income in 2014. At the same time, the proportion of income from farm income, which has the highest misreporting rate, decreased from 4.6 percent in 2014 to 4.4 percent in 2016. All combined, the change in income sources reduces the estimated tax gap for full year residents of Montana before credits from 22.9 percent in 2014 to 21.7 percent in 2016.